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SEC Issues Rules Implementing Certain Provisions Of The FAST Act

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

On May 3, 2016, the SEC issued final amendments to revise the rules related to the thresholds for registrations, termination of registration, and suspension of reporting under Section 12(g) of the Securities Exchange Act of 1934. The amendments mark the final rule making and implementation of all provisions under the JOBS Act, and implement further provisions under the FAST Act.

The amendments revise the Section 12(g) and 15(d) rules to reflect the new, higher shareholder thresholds for triggering registration requirements and for allowing the voluntary termination of registration or suspension of reporting obligations. The new rules also make similar changes related to banks, bank holding companies, and savings and loan companies.

Specifically, the SEC has amended Exchange Act Rules 12g-1 through 12g-4 and 12h-3 related to the procedures for termination of registration under Section 12(g) through the filing of a Form 15 and for suspension of reporting obligations under Section 15(d), to reflect the higher thresholds set by the JOBS Act. The SEC also made clarifying amendments to: (i) cross-reference the definition of "accredited investor" found in rule 501 of Regulation D, with the Section 12(g) registration requirements; (ii) add the date for making the registration determination (last day of fiscal year-end); and (iii) amend the definition of "held of record" to exclude persons who received shares under certain employee compensation plans.

The new rules were initially proposed on December 18, 2015. A few days before the proposed rules were issued, on December 4, 2015, the FAST Act was enacted into law, including provisions implementing the revised thresholds for savings and loan holding companies, effective immediately without further action by the SEC. Despite this overlap, the SEC has now cleaned up all the provisions, thus aligning the rules with the statutory requirements.

Following the final implementation of the relevant JOBS Act and FAST Act provisions, a company that is not a bank, bank holding company or savings and loan holding company is required to register under Section 12(g) of the Exchange Act if, as of the last day of its most recent fiscal year-end, it has more than $10 million in assets and securities that are held of record by more than 2,000 persons, or 500 persons that are not accredited. The same thresholds apply to termination of registration and suspension of reporting obligations. As discussed below, determining which shareholders are accredited as of the last day of a fiscal year-end can be difficult.

A company that is a bank, bank holding company or savings and loan holding company is required to register under Section 12(g) of the Exchange Act if it has more than $10 million in assets and securities that are held of record by more than 2,000 persons and is allowed to terminate or suspend registration if its securities are held of record by fewer than 1,200 persons.

Registration, Termination of Registration and Suspension of Reporting Obligations

The JOBS Act amended Sections 12(g) and 15(d) of the Exchange Act to adjust the thresholds for registration, termination of registration and suspension of reporting. Prior to enactment of the JOBS Act on April 5, 2012, the Exchange Act required companies with greater than $10 million in total assets and greater than 500 record holders of any class of equity security to register and file periodic reports with the SEC. This requirement was burdensome for companies aspiring to raise capital and grow but that were not yet ready to become publicly reporting.

Section 12(g) of the Exchange Act and the rules promulgated thereunder allowed a company to deregister and relieve itself of the reporting requirements of the Exchange Act if it has fewer than 300 shareholders, or fewer than 500 shareholders and less than $10 million of assets.

Non-bank, Bank Holding Company and Saving and Loan Holding Company Issuers

Title V and Title VI of The JOBS Act amended Section 12(g) and Section 15(d) of the Exchange Act. Section 501 of Title V amended Section 12(g) of the Exchange Act to increase the "holders of record" threshold for triggering Section 12(g) registration for issuers with total assets of more than $10 million (other than banks and bank holding companies) from 500 or more persons to either (i) 2,000 or more persons or (ii) 500 or more persons who are not accredited investors. Issuers are required to register within 120 days after its fiscal year-end, if on the day of such fiscal year-end, it meets these thresholds.

Although Section 501 went effective upon passage of the JOBS Act, the automatic amendments did not include a change to the deregistration provisions under Section 12(g). Accordingly, since April 2012, a company would not be required to register until it had 2,000 shareholders of record or 500 or more persons who are not accredited investors, but could not deregister unless it had fewer than 300 shareholders, or 500 shareholders for those companies with less than $10 million in assets.

The new rules have now aligned the right to terminate registration or suspend reporting obligations with the higher threshold amounts.

With the passage of the new rules, together with all the JOBS Act rules enacted previously, a company is not required to register a class of securities under Section 12(g) if, on the last day of its most recent fiscal year: (i) the company has total assets not exceeding $10 million; or (ii) the class of securities is held of record by fewer than 2,000 persons or 500 persons that are not accredited as defined in Securities Act rule 501.

Bank, Bank Holding Company and Saving and Loan Holding Company Issuers

Section 601 of the JOBS Act amended Section 12(g) to increase the total assets to $10 million and the holders of record threshold for triggering registration for banks and bank holding companies, as such term is defined in the Bank Holding Company Act of 1956, as of any fiscal year-end after April 5, 2012, from 300 or more persons to 2,000 or more persons. Similarly, Section 601 of the JOBS Act amended Sections 12 and 15 of the Exchange Act to increase the holders of record threshold for deregistration and suspension of reporting obligations for banks and bank holding companies from 300 to 1,200 persons.

Following enactment of the JOBS Act, regulators realized that the Section 601 provisions had inadvertently left out saving and loan holding companies from the new registration and deregistration threshold changes. Accordingly, both the SEC through rule making, and the legislature through the FAST Act, have implemented changes to correct the oversight and include saving and loan holding companies in these changes. Following implementation of the FAST Act, the SEC also issued guidance through Compliance and Disclosure Interpretations (C&DI) to help clarify the provisions. My blog on that guidance can be read HERE.

The new rules clean up the procedures and timing of termination of registration for banks, bank holding companies and savings and loan holding companies as well such that these entities may immediately terminate registration upon the filing of a Form 15 rather than the existing procedures, which required the entities to wait 90 days after filing the Form 15 to be relieved of their obligations. Similarly, the existing procedures only allowed for the suspension of reporting obligations at the beginning of a fiscal year. The new rules allow banks, bank holding companies and savings and loan holding companies to suspend reporting obligations, effective immediately, at any time during the year by filing a Form 15, as long as they meet the thresholds for such suspension.

Application of the Increased Threshold for Accredited Investors

Knowing whether an investor or shareholder is accredited has always been a basic premise in determining the availability of an exemption from the registration requirements and the disclosure delivery requirements applicable to such an exemption. The new registration and deregistration thresholds now extend the importance and timing of knowing the accredited status of shareholders beyond what was ever previously required.

Identifying accredited investors for purposes of the registration, and especially deregistration, requirements could be problematic. Suggestions in this regard included: (i) allowing issuers to rely on annual affirmations from record shareholders; (ii) reliance on information obtained at the time of an initial investment or most recent sale of securities to such investor; or (iii) third-party verification.

The new rules rely on the current definition of “accredited investor” enumerated in Securities Act Rule 501(a) and require that the “accredited investor” determination be made as of the last day of the fiscal year rather than at the time of the sale of securities. This provides a dramatic change for issuers who currently have no obligations to assess accredited status after a sale of securities is completed.

In rejecting the ability to unilaterally rely on representations made at the time of a sale of securities to a particular investor, the SEC expressed concern regarding the use of outdated, unreliable information. Instead, an issuer will need to determine, based on facts and circumstances, whether it can rely upon prior information to form a reasonable basis for believing that the security holder continues to be an accredited investor as of the last day of the fiscal year.

The new rule requires the company to have a reasonable belief as to whether a shareholder is accredited. The SEC is leaving it to the discretion of the company to determine, based on facts and circumstances, whether it has a reasonable belief that a shareholder is accredited or not. A company is not precluded from relying on prior information if it has a reasonable belief that such information is still accurate, such as based on the close proximity to the time of sale. The SEC notes that sale information can be years or even decades old, in which case the issuer could not, of course, rely on such prior information.

However, this begs the practicality question of how exactly that issue will gain the information. The SEC declined to offer guidance, establish a safe harbor, or otherwise provide any assistance to companies in this regard.

It seems to me that issuers will now need to obtain contractual agreements from investors to provide updated representations; however, determining fair and reasonable consequences for a breach of such an agreement is problematic. Direct damages will be hard to determine. I doubt an issuer could claim that the shareholders' refusal to provide updated information results in the issuer having to register, or continue reporting, and seek damages in the amount of reporting costs. Likewise, investors will balk at consequences directed toward their share ownership, such as a restriction on voting or dividend rights, though remedies along these lines seem the most workable.

As the proliferation of rules centered on a distinction between accredited and non-accredited investors continues, the definition of accreditation has become the subject of much debate and the SEC is considering, and ultimately will implement, changes to the definition.

Employee Compensation Plans; Determining Holders of Record

The new rules establish a non-exclusive safe harbor that companies may follow to exclude persons who received securities pursuant to employee compensation plans when calculating the shareholders of record for purposes of triggering the registration requirements under Section 12(g). Exchange Act Section 12(g)(5) as amended of the JOBS Act provides that the definition of "held of record" shall not include securities held by persons who received them pursuant to an "employee compensation plan" in exempt transactions. By its express terms, this new statutory exclusion applies solely for purposes of determining whether an issuer is required to register a class of equity securities under the Exchange Act and does not apply to a determination of whether such registration may be terminated or suspended.

The new rule implements the JOBS Act by establishing a statutory exclusion for security holders who received their stock in unregistered employee stock compensation plans, and provides a safe harbor for determining whether holders of their securities received them pursuant to an employee compensation plan in exempt transactions.

The SEC declines to add a new definition of "employee compensation plan"; rather, the SEC incorporates Rule 701(c) and the guidance under that rule for issuers to rely on in their Section 12(g) analysis. The proposed safe harbor allows an issuer to conclude that shares were issued pursuant to an employee compensation plan in an unregistered transaction as long as all the conditions of Rule 701(c) are met, even if other requirements of Rule 701, such as 701 (b) (volume limitations) or 701(d) (disclosure delivery requirements) are not met.

The new Rule amends the definition of "held of record" such that for purposes of Section 12(g), an issuer may exclude securities that are either:

- held by persons who received the securities pursuant to an employee compensation plan in transactions exempt from, or not subject to, the registration requirements of Section 5 of the Securities Act or that did not involve a sale within the meaning of Section 2(a)(3) of the Securities Act; or

- held by persons who received the securities in a transaction exempt from, or not subject to, the registration requirements of Section 5 from the issuer, a predecessor of the issuer or an acquired company, as long as the persons were eligible to receive securities pursuant to Rule 701(c) at the time the excludable securities were originally issued to them.

- The SEC also excludes securities issued under the "no-sale" exemption to registration theory from the "held of record" definition, including shares issued as a dividend to employees. That is, the SEC is excluding securities that did not involve a sale within the meaning of Section 2(a)(3), as well as exempt securities issued under Section 3 of the Securities Act. Examples of securities issued under Section 3 include exchange securities under sections 3(a)(9) and 3(a)(10).

The new rules are meant to encompass securities issued in exchange for or related to business combination transactions, as long as the employee or former employee was eligible to receive the securities under Rule 701(c) at the time of original issuance.

The new rules related to determining securities "held of record," including both determinations of accredited investors and shareholders that have received shares under employee compensation plans, are complicated and will require meticulous record keeping, chains of title, and follow-up. I imagine that either transfer agents or separate third-party service providers will need to offer tracing services to assist companies in maintaining these records and meeting their registration requirements.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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